Investment delocalization: challenges and opportunities

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Theme: The diversion of Foreign Direct Investment (FDI) from Spain to the new EU members through the growing practice of 'delocalizing' production units calls for new and innovative public policies to enable Spain to attract foreign investment in higher value-added sectors.

Summary: This article aims to clarify the phenomenon of delocalization, disprove some of the most common myths behind FDI and highlight the challenges and opportunities confronting Spain. Only by investing heavily in education, new technologies and R&D will Spain be in a favourable position to take full advantage of economic globalisation.

Analysis: Industrial delocalization is one of the most controversial issues of globalisation. In Spain, the magnitude of the unemployment problem and the recent wave of delocalizations are stoking fears of new competition from less-developed "lower-wage" countries and economies in transition. According to the Spanish National Statistics Institute (INE), 94,800 jobs were lost in the industrial sector during 2003. Textiles, footwear, electronics, and automobiles –which in Spain account for 8.5% of GDP, 13% of employment and 30% of exports–, are the most affected sectors. Moreover, well-known firms such as Samsung, Phillips, Panasonic, Nissan, Volkswagen, Zara and Mango have recently decided to either close down their Spanish plants or produce some of their goods abroad. Catalonia is the Spanish region to have suffered the most from these controversial business decisions.

This phenomenon is having an effect on workers from virtually all industrialised nations, and the debate around this issue has become increasingly political, especially in the US, where demonising capital and free trade has become the national sport. In the case of Spain, three recent phenomena are nourishing these fears. First, the economic boom of developing countries such as India and China. Secondly, the imminence of EU enlargement and the resulting diversion of FDI from Spain to the new EU members through the growing practice of 'delocalizing' production units. And, thirdly, the recent world-wide reduction in FDI flows, which has further complicated FDI attraction in an ever more competitive environment.

Delocalization is a contentious issue, subject to a great deal of confusion. In order to set the issue within the boundaries of an informed debate, this article aims to clarify the phenomenon of delocalization, disprove some of the most common myths behind FDI and last, but not least, highlight the challenges and opportunities confronting Spain.

The world-wide increase of FDI and the spread of delocalization practices over the past decade are direct consequences of the two main underpinnings of world economic integration and inter-dependence (ie, globalization): trade/financial liberalization and

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technological progress. Technological change has reduced transaction costs and the economic distance between countries, thereby allowing new kinds of production networks, financial instruments and business strategies. Pushed by ever-increasing competition, Multinational Corporations (MNCs) have adapted to the new playing field by transforming themselves into Global Production Networks.

But not all factors of production are as mobile. Globalization has accentuated an inequality between firms and workers that was not so visible before and that explains why adjustment to delocalization is so painful: whereas firms can delocalize relatively easily, workers have become the least mobile factor of all. Workers, especially unskilled workers, cannot adjust so easily to geographical mobility.

While most OECD countries are net importers of workers from developing countries, Spanish, French and even US workers will not delocalize to the areas to which investments are currently relocating. This dynamic accentuates the fears among the labour force and serves as a pretext to demonise the free flow of capital, labour, goods and services. Spain, however, has benefited enormously from FDI during the past few decades. Now that it ranks amongst the world's most developed economies, rather than fall into the protectionist temptation, it should instead recognize that its growth model –so successful over the last half century– now needs to be modified to benefit from new circumstances.

Labour costs and delocalization

Most commentators of the current wave of delocalizations offer a gloomy picture based on the assumption that labour costs drive the localization of firms. Spanish workers, so the story goes, cannot compete with cheaper Polish or Slovenian workers. But is it really that simple? For instance, how can we explain the fact that, as reported by UNCTAD, developed countries account for two thirds of the world's stock of FDI and that only ten of the 30 countries that receive the largest FDI flows are developing or transition economies?

The reason is that wages alone are not the vital factor for a MNC. Labour costs are just one factor within the foreign investment equation. MNC's foreign investment decisions are based on productivity and competitiveness. Furthermore, wages are determined by labour productivity, which tends to be higher in developed countries, therefore explaining why wages are higher in industrialized countries than in less developed countries.

The cause-and-effect argument about labour costs and FDI localization brings to mind the analogous view according to which there is a close link between globalization, growing trade and declining wages in industrialized countries. This parallel and equally controversial argument has been notoriously rebutted by Paul Krugman and others. Solidly supported by readily available data, Krugman has shown that the decline in manufacturing employment and in the real wages of production workers is primarily a consequence of domestic conditions (namely technological development and productivity trends), not increased international trade. Therefore, the entry of new players into the world market does not necessarily penalise those who are already there.

The competitive advantage of a firm located in a specific country depends on a wide variety of factors. According to the International Institute for Management Development (IMD), these include: (a) economic performance (domestic economy, international trade, international investment, employment and prices); (b) government efficiency (public finance, fiscal policy, institutional framework and business legislation); (c) business efficiency (productivity, labour market conditions, and management practices, attitudes and values); and (d) infrastructure (basic infrastructure, technological infrastructure, scientific infrastructure, health and environment, and education levels).

In short, it would be a mistake to picture delocalization flows from Spain to CEEC (Central and Eastern European Countries) as a process of 'production flight' to the cheapest-labour economies.

With this framework in mind, there are other issues that remain contentious.

FDI is not beneficial by itself
FDI is often seen as an inherently positive economic development. But FDI is not beneficial by definition. Indeed, FDI should not be seen as an objective in itself but, instead, as a means for promoting the achievement of national development goals.

The impact of MNCs depends on the amount and quality of the 'integrated packages' they generate compared with the packages that would otherwise be generated by domestic firms. Therefore, in determining whether foreign investments benefit the host country, the counterpoint is crucial: what would happen if they do not take place? What kind of packages could be generated internally? It goes without saying that a second discrimination is also necessary in a world of limited resources: what kind of FDI can contribute "the most" to growth and to the competitiveness of the national economic base? In order to answer these questions, it is necessary to explore where the benefits of FDI lie.

Benefits from FDI: jobs, jobs… but only jobs?
Public debate about FDI tends to be centred upon its impact on employment. And benefits from FDI tend to be valued in terms of direct job creation. This is particularly so in Spain, a country where unemployment has been "public enemy number one" for a long time, and for good reason. The social alarm created by the current wave of delocalizations has only increased the perceived link between FDI and employment in the public debate.

The visible and rapid creation of employment is a fundamental political priority. Indeed, public perception of the employment issue is crucial for assuring re-election. Yet the briefness of the political cycle diminishes political incentives to promote much needed (job-creating) structural reforms, the impact of which will only be evident and rewarded over a much longer period of time. That is partly the reason why the authorities seem to forget that the value of FDI does not come primarily from the creation of employment or the provision of capital, but from a transformation in the range of productive activities available to the host country. The greatest contribution of FDI comes through integrated packages –technologies, business techniques, management skills, HR and marketing capabilities– that place host country plants on the frontier of industry "best practices" and keep them there. In this way, FDI allows host-economy actors to undertake entirely new activities as well as carry out existing activities more efficiently.

Immediate and direct job creation is therefore a superficial and misleading way to assess the benefits of FDI. From an economic development perspective, the most important potential benefits of FDI come through a virtuous cycle that facilitates and improves available productive capacities, thereby creating more and better jobs with higher rewards and better conditions, in keeping with higher productivity.

Only by attracting MNCs high value-added production (of goods and, even more importantly, of services), and by supporting high-end export-oriented projects that are closely integrated into the parent corporation's sourcing network, will Spain benefit from FDI and place itself in the best situation to grow (along with firms) into higher value-added activities.

Only FDI such as this will be instrumental for the attainment of sustainable economic growth, reduction of unemployment and promotion of higher job quality over the middle and long-run. More and better jobs are not conflicting goals; rather, over the longer term they should and can be mutually reinforcing objectives.

The nature of the CEECs competition
It has already been concluded that low labour costs are not the only factor driving delocalization and FDI. Incentives for foreign investment, public investments in telecommunications infrastructures and skills, support to R&D and high productivity are some of the factors of localization for MNCs.

In this regard, the majority of the CEEC countries offer relatively high productivities (thanks mainly –but not exclusively– to low-cost yet relatively skilled labour), good prospects for growth and geographical proximity to the most prosperous areas within the Union.

It appears that multinationals have two objectives when investing in CEECs: to supply the increasingly vibrant domestic market and to take advantage of the mix of low labour costs plus high productivity by setting up the most work-intensive stages of production in these countries.

Yet most CEEC-bound FDI comes from Europe rather than the US, is market seeking rather than export oriented, and appears to be of the low-tech type that Portugal and Spain attract rather than the high-tech type that Ireland, for instance, attracts. On the basis of this evidence, and following the conclusions of Raymond Vernon's "Product Cycle Theory", it seems likely that in the coming years "low tech" direct investment will continue to flow from Spain and current EU members to the CEEC.

Challenges, opportunities and policy implications
The increase in economic interdependence and the liberalisation of the international financial markets have made it harder for governments to rely on the traditional fine-tuning management of macroeconomic policies that characterized the Keynesian postwar era. With globalization, market responses and sanctions to countries that implement unsound policies are almost automatic.

Policy making is thus constrained by globalization, but this does not mean that government policies have no room for manoeuvre. Actually, the case is quite the opposite: foreign market access and national attractiveness vis-à-vis foreign investments have become important objectives for policy making. In the current highly-integrated economic world, one of the biggest challenges for policy-makers is, therefore, to design and implement a balanced and attractive framework for investments. In fact, according to UNCTAD's 2003 World Investment Report, in 2002, 70 countries introduced changes in their investment regimes and 236 of 248 regulatory reforms were aimed at facilitating inward FDI flows.

Globalization and speed, the story continues, are also producing early market signals, which can be used to avoid crises and improve economic performance. Well, the signals are clear: the Spanish economy is not ready to face the challenge of the new wave of delocalization. Are any solutions ready?

Spanish industry runs the risk of being displaced from FDI flows if the right measures are not taken to reinforce and improve the location advantages associated with the Spanish economy.

Spain is not losing ground, as is often claimed, because of the competition from lower-wage countries. Rather, Spain is in danger of slipping behind because it maintains declining relative productivity and competitiveness rates that prevent it from shifting towards higher value-added activities and more sophisticated investment. According to Guillermo de la Dehesa, from 1996 to 2002 productivity per hour worked in Spain increased by only 0.84% per year, compared with 1,36% in the EU and 1,9% in the US. Measuring the evolution of productivity levels per employed worker, Dehesa finds even more discouraging results: taking 100 as the average EU level, Spain ranks in the 81st percentile and the US stands at 119. Finally, in total factor productivity levels, Spain is still 15 percentage points below the EU average and 27 percentage points below the US. These figures show that even though the Spanish economy has experienced relatively high growth rates in the past few years due to a real estate boom and low interest rates, it is not in an optimal competitive position to attract larger shares of FDI and quickly transform its productive infrastructure.

According to the International Institute for Management Development (IMD), which produces an annual World Competitiveness ranking, after three years of unchanged competitiveness, Spain fell in 2003 from the 8th to the 9th place among the countries with a population greater than 20 million. In addition, according to the rankings prepared by the World Economic Forum (WEF), Spain has fallen from the 21st to the 23rd position in the Growth Competitiveness Index, which estimates the underlying conditions for growth over the coming years.

In short, Spain is not in the best position to take advantage of economic globalization. And yet behind every obstacle there lies an opportunity. Spain should seize the challenge posed by the new wave of delocalization to deliver the adjustments that will make such a development less likely in the future.

In a context where investment in the CEEC is mostly of the low-tech type that Portugal and Spain attract rather than the high-tech type, and while Germany, France, the Netherlands and the UK are moving towards new sectors of innovation such as biotechnology, IT, banking and insurance, Spain should aim to make a qualitative jump towards a higher value-added, knowledge-based economy. Therein lies the challenge and opportunity.

In order to face the challenge and seize the opportunity, policy-makers should aim at something more than “macroeconomic management”. They should actively promote a coherent strategy that allows the growth of knowledge-intensive economic activity and, therefore, employs FDI to promote positive and lasting development.

Nevertheless, it is essential that such a policy not be associated with the promotion of desirable industries or national champions. Policy makers should rather work to foster the conditions that contribute to the international competitive position of global firms in high value-added activities. In other words, Spain should succeed in placing Spanish plants (of national or international ownership) at the forefront of industry “best practices” and keeping them there.

Instead of providing short-term “ad hoc” sweeteners (fiscal advantages and other types of subsidies) to MNCs that bring jobs but do not bring technologies, business techniques, management skills, HR and marketing capabilities, Spain should implement policies that bring about the conditions for the creation of more, better and less-vulnerable jobs.

The available empirical evidence points to several relatively uncontroversial directions for Spain’s public policy: increasing and improving workforce skills and competencies; extending and promoting new technologies; and encouraging innovation through new knowledge and market opportunities.

First, there is a need to invest in highly-skilled labour. Endogenous growth theory highlights that human capital is a key component in raising total factor productivity because it most likely exhibits increasing returns to scale. Constrained by the incentives of a short-term political cycle, policy makers tend to favour investment in short-term impact initiatives (with the prospect of immediate political rewards) instead of implementing policies that, like education, yield better results in the long run. Unfortunately, this has been the case in Spain. As a result, according to Dehesa, Spain's expenditure per student is still at 60% of the average EU level and the percentage of primary and secondary schools that do not have personal computers in Spain is three times higher than the EU average (32% versus 11%). At the university level (both graduate and post graduate), and particularly at the level of vocational training (formación profesional), Spain lags behind most developed nations. Only 37.5% of Spanish students that complete secondary education continue into professional training programmes, compared with over 57% in the EU. Finally, only 26.5% of Spanish workers receive ongoing training at their workplace, compared with 57.4% in the EU. Improving the social prestige of vocational training programmes among young workers and increasing the scope of training within firms are key elements for matching the skills of the labour force with new market demands.

Second, the lack of sufficient investment in new technologies also appears to be a major handicap for development. Spain ranks 29th in the WEF's 2003 Network Readiness Report (which uses the Networked Readiness Index –NRI– to measure 'the degree of preparation of a nation or community to participate in and benefit from ICT developments'). The level of penetration of new technologies in Spain is significantly lower than the EU average, especially among small and medium-sized enterprises.

Third, R&D spending should be increased in order to improve the competitiveness of Spanish firms and to avoid the scientific brain drain of both young and experienced scientists. Spain's R&D expenditure is still low compared with the EU average: it is still below 1% of GDP, half the EU average and below the level of countries such as Slovenia, Hungary and the Czech Republic. Possible initiatives to increase investment in R&D include raising the expenditure in education and training, particularly at the technical, marketing and general management level, promoting university-industry interaction that can foster university spin-offs, and providing financial support to universities and other institutions carrying out pre-competitive research. The goal of this support is to create a local infrastructure of scientists, engineers, business experts and operating companies integrated into a unique network of specialized expertise with entrepreneurial and international ramifications.

Fourth, in order to compensate for a geographical location that will become more peripheral in the context of an enlarged EU, Spain needs to improve its basic transport and communication infrastructure, but also increase investment in the development of technological capital.

Fifth, a pool of relatively fluent English-speaking skilled labour represents an important factor of localisation, as the Irish experience corroborates. Spain lags behind the EU average in second language penetration. Globalization offers new opportunities, but only for those who speak the new lingua franca, English. Investment in more and better language training is therefore essential if Spain wishes to exploit the advantages globalization brings.

Last, but not least, there is a need to make the Spanish labour market more dynamic. Key goals include an increase in part-time work, in which Spain has one of the lowest rates of the EU, a further increase in women's participation in the labour force, the reduction of non-wage labour costs and the substitution of precarious employment for fixed contracts, especially among young workers.

Conclusions

Implications at the EU level

Spain is not alone in the push for a more knowledge-based economy. The Lisbon Agenda, which aims to transform Europe into the most dynamic knowledge-based economy in the world by 2010, is a strategic plan endorsed by all EU members. What is at stake is nothing less than the European Social Model, only sustainable if Europe begins to catch up with US innovation and productivity rates.

Competition for FDI within the EU is not a negative phenomenon: it fosters innovation and stimulates change and constant adaptation. However, competition should not grow into what has come to be known as "a race to the bottom". Direct subsidies and fiscal advantages should be left out of the playing field. FDI is, therefore, another sector that would benefit from an EU-wide harmonization of fiscal conditions. An EU-wide minimum corporate tax would certainly be an initiative in the right direction.

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